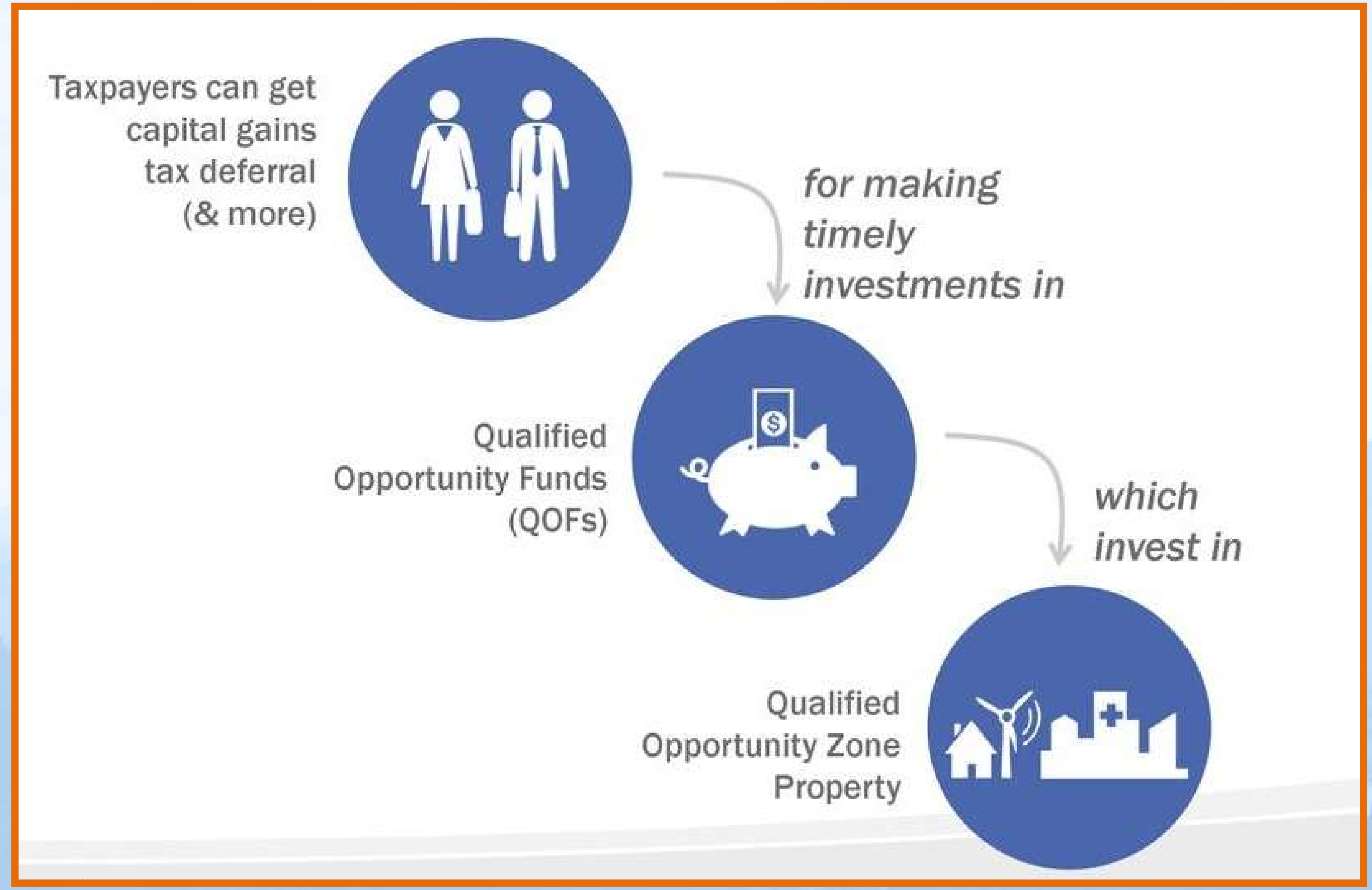
A World of Opportunity

Rules, Regulations and Remarks Regarding Qualified Opportunity Zones

Qualified Opportunity Zones in a Nutshell



A Bipartisan Effort

115th CONGRESS
1st Session

S. 293

To amend the Internal Revenue Code of 1986 to provide for the deferral of inclusion in gross income for capital gains reinvested in opportunity zones.

IN THE SENATE OF THE UNITED STATES

February 2, 2017

Mr. Scott (for himself, Mr. Booker, Mr. Blunt, Mr. Bennet, Mr. Graham, Mr. Coons, Mrs. Capito, Mrs. Gillibrand, Mr. Peters, Mr. Gardner, Mr. Young, and Mr. Warner) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1986 to provide for the deferral of inclusion in gross income for capital gains reinvested in opportunity zones.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Investing in Opportunity Act".

Senator Shelley Moore Capito (R-WV) and Senator Tim Scott (R-SC); Senator Cory Booker (D-NJ) and Senator Scott

What Makes Opportunity Zones Unique?

- Pertains exclusively to capital gains
- Concentrates capital
- Rewards patient capital
- Unlocks scarce equity capital
- Provides no up-front subsidy
- Moves at the speed of the market
- Designed with startups in mind
- Gives investors a stake in a community's future

Three Core Elements to Opportunity Zones

1. **Zones:**
   States and territories designated up to 25 percent of Low-Income Community Census tracts in their state to be certified by Treasury as Opportunity Zones.

2. **Funds:**
   Opportunity Funds are self-certified investment vehicles organized as corporations or partnerships for the purpose of investing in qualified Opportunity Zone assets. All investments that seek to take advantage of the provision must flow through Funds.

3. **Investments:**
   Funds make equity investments into business and property in Opportunity Zones. Qualified assets are the stocks of qualified companies, interests of qualified partnerships, or direct ownership of qualifying tangible property.

3½ Tax Incentive Benefits

1. Gain Deferral

2. Partial Forgiveness

3. Forgiveness of Additional Gains

3 ½. Time Value of Money from Deferral

Benefits Scenario

- You invested $3 MM in 2015 in ABC Manufacturing
- You sold the stock in 2019 for $4 MM
- You invest the gain in a Qualified Opportunity Zone Fund
- Leaving you the remaining $3 MM of proceeds to use as you like

180-Day Rule

- Taxpayers must invest an amount equal to the gain to be deferred in a QOF within 180 days of the sale of the property.
- The 180-day period begins on the day on which the gain would be recognized if the taxpayer did not elect to defer recognition of that gain.
- Proposed regulations list the following examples illustrating the rule:

Example	Beginning of the 180-day period
Regular-way trades of stock	On the trade date
Capital gain dividends received by RIC and REIT shareholders	On the day on which the dividend is paid
Undistributed capital gains allocated to shareholders by RICs and REITs shareholders	On the last day of the RIC's or REIT's taxable year

Special Partnership Rules for Deferring Gain

- Special rules for partnerships and other pass-through entities deferring gain by investing in a QOF:
  - The Partnership's 180-day clock begins on the date that the partnership recognized the capital gain.
  - If Partnership passes through the gain, the 180-day clock does not begin until the last day of the partnership's taxable year (because that is the day on which the partner would be required to recognize the gain if not deferred).
  - Partners may elect to begin its own 180-day period on the same date as the start of the Partnership's 180-day period.
  - Section 1256 net income: the 180-day period begins on the last day of the taxpayer's taxable year (even if one or more Section 1256 contracts have been disposed of during the year).

The 10-Year Rule

- A taxpayer is entitled to step up to its basis in its investment in a QOF to fair market value if it has held that investment for at least 10 years.

- Possibility to avoid any tax on the disposition of the QOF investment:
  - Taxpayers who have not met the 10-year holding period by December 31, 2026 can merely continue to hold their investment until the 10-year holding period is achieved, despite their QOF technically ceasing to be one.

  - Step-up to fair market value for any sale of an interest in a QOF allowed until December 31, 2047.

Disposition of the Investment

- **General rule:** The original deferred gain from the sale of the capital asset must be recognized by the taxpayer at the earlier of 2026 and the date on which the taxpayer sells its interest in the QOF.

- However, a taxpayer may use its QOF's interest as collateral for a loan, whether as part of a purchase-money borrowing or otherwise, without triggering the deferred gain.

- Generous provisions for roll-overs:
  - If a QOF disposes of qualified opportunity zone business property, the taxpayer may maker a qualifying investment in a new qualified opportunity business property and continue to defer the original gain.
  - The gain must be triggered – and rolled over – by the end of the date at which all deferred gains must be recognized.
  - Waiting for more regulations to address if the gain from QOZ property must be a "capital" to roll it over.

Attributes of Included Income As Gain Deferral Ends

- At the end of the deferral period, a taxpayer must include in income the excess of:
  i. The lesser of (A) the eligible gain that the taxpayer rolled-over, or (B) the fair market value of the taxpayer's QOF's investment as of the end of the deferral period over
  ii. The taxpayer's basis for the QOF investment

- The gain to be included has the same attributes in the taxable year of inclusion that it would have had if tax on the gain had not been deferred.

- These attributes include those taken into account by Sections 1(h), 1222, 1256 and any other applicable provisions of the Code.

Tax Benefits for Deferred Gain

2018
- Defer paying $200,000 tax on gain (i.e., 20% on $1MM gain)

2023
- $20,000 of tax forgiven (5-year holding period for 10% tax reduction)

2025
- $10,000 of tax forgiven (7-year holding for 5% more reduction)

2026
- Regardless of holding period: must pay $170,000 of tax (i.e., $200,000 less $30,000), so 17% tax rate on $1MM gain from 2018.

Tax Benefits for Opportunity Zone Investment

2018

- $1MM investment in QOF with zero outside tax basis.

2023

- $100,000 outside tax basis increase.

2025

- $50,000 outside tax basis increase.

2028 to 2047

- Outside tax basis in the Fund increases to fair market value of Fund interest (i.e., can sell Fund interest with no tax) at the time of sale of the interest; provided, met 10-year holding period and before end of 2047.

Partial Forgiveness: Forgiveness of Additional Gains

Timeline

- **2019 to 2024**
  - Sale and investment.
  - Held for 5 years, basis increased by 10% of the deferred gain.
  - Up to 90% taxed.
- **2024 to 2026**
  - Held for 7 years, basis increased by 5% of the deferred gain.
  - Up to 85% taxed.
- **2026 to 2029**
  - Held for 10 years, basis is equal to Fair Market Value.
  - Thus: forgiveness of gains on appreciation of investment.
  - Requires an election.

Partial Forgiveness: Forgiveness of Additional Gains

Example:

- **2019**
  - **<u>January 2:</u>** Taxpayer enters into a sale that generates $1M of capital gain.
  - **<u>June 30 (within 180 days)</u>:** Taxpayer contributes entire $1M of capital gain to a Qualified Opportunity Fund.
    - ✓Taxpayer is deemed to have a $0 basis in its QOF investment
    - ✓QOF invests the $1M in QOZ Property

- **2024**
  - **<u>June 30 (After 5 years)</u>:** Taxpayer's basis in QOF investment increases from $0 to $100k.

Partial Forgiveness: Forgiveness of Additional Gains

Example:

- **2026**
  - **June 30 (After 7 years):** Taxpayer's basis in QOF investment increases from $100k to $150k.

- **2027**
  - **December 31:** $850k of the $1M of deferred capital gains are taxed and the basis in QOF investment increases to $1M.

- **2029**
  - **June 30 (after 10 years):** Taxpayer sells its investment for $2MM. Basis in the investment is deemed to be FMV. The effect is no tax on appreciation in investment.

Eligible Gains and Eligible Taxpayers

- Only capital gains from both actual and deemed sales or exchanges, including:
  - Section 1231 gain (from the sale of real estate used in trade or business).
  - Unrecaptured Section 1250 gain ("capital gain" taxed at a higher rate).
  - Depreciation recapture is not eligible for deferral

- Individuals, C corporations (including a regulated investment company (RIC) or real estate investment trust (REIT)), partnerships, S corporations, and trusts or estates are all eligible taxpayers.

- Partnerships and other pass-through entities are eligible to defer gains by investing in a QOZ directly.
  - Partnerships can elect to pass-thru gains to individual partners, who may elect to defer their own allocable shares

1245 and 1250 Recapture of Depreciation

- Sections 1245 and 1250 were enacted to close the loophole that resulted from allowing depreciation deductions on assets to offset ordinary income while taxing gain from the sale of these depreciated assets as capital gains.
- Sections 1245 and 1250 close the loophole by recharacterizing part or all of the gain on transfers of depreciable assets as ordinary income.
- Sections 1245 and 1250 generally apply to any transfer of depreciable property (including certain property that is expensed under rules similar to depreciation rules, such as rapid amortization property and property that has been expensed under §179). Certain transfers of depreciable property, however, are excepted from depreciation recapture.

Source: Bloomberg Tax and Accounting

- **BEWARE:** Accelerated depreciation deductions required to be recaptured under Sections 1245 and 1250 upon transfer of depreciable property subject to those sections, are <u>not</u> considered part of the capital gains that can be invested in a Qualified Opportunity Fund and do not receive the benefits of such an investment (e.g., no gain deferral).

Special Rules: Section 1256 Contract and Straddles

- Gain and loss are recognized on the market-to-market method of accounting.
- 60% long-term capital gain or loss and 40% short-term capital gain or loss.
- Holders of Section 1256 contracts are required to net gains and losses and only treat the amount of any net gain as eligible for an investment in a QOF.
- If a Section 1256 contract is held as part of a straddle transaction, any gain from that contract is not eligible gain that can be deferred through an investment in a QOF.
- Proposed Regulations treat a transaction as a straddle for this purpose even if the offsetting position is not a position with respect to publicly traded property.
- If any Section 1256 contract is part of an offsetting position transaction with a position that is not a Section 1256 contract, no Section 1256 net income may be deferred through an investment in a QOF.

West Virginia State Tax Implications / Effects

- **H.B. 113** was enacted and signed into law this summer and became effective a little over a month ago. This new law adds Sections 11-21-12k (personal income tax) and 11-24-6b (corporation net income tax) to the W.V. Code.
- **H.B. 113** provides a significant tax benefit and incentive to taxpayers (individuals, partnerships, LLC's treated as partnerships and other pass-through entities, and corporations) who invest in a "newly registered business" that constitutes a "Qualified Opportunity Zone Business" located in one of the "Qualified Opportunity Zones" as defined under Sections 1400Z-2 and 1400Z-1, respectively, of the Internal Revenue Code of 1986, as amended.
- Essentially, a modification reducing federal adjusted gross income is made for tax years beginning on and after January 1, 2019 for eligible taxpayers.
- For individuals and partners or members of LLC's and other pass-through entities, the modification is in an amount equal to the portion of net income (or distributable flow-through income) that is included in federal taxable income in a taxable year that is derived from a Qualified Opportunity Zone Business located in a Qualified Opportunity Zone in West Virginia. See §§11-21-12k(a).

West Virginia State Tax Implications / Effects

- For corporations, the modification is an amount equal to the net income included in federal taxable income of a corporate taxpayer in a taxable year that is ordinary income derived from a Qualified Opportunity Zone Business located in a Qualified Opportunity Zone in West Virginia. See §§11-24-6b(a).
- The Qualified Opportunity Zone Business must be a "newly registered business" is a business that "is first required to obtain a business registration certificate from the Tax Commissioner on or after January 1, 2019 and before January 1, 2024. See §11-21-12k(d)(2) (definition of "Newly registered business").
- To qualify, such business cannot be a "reorganization of a business that existed prior to January 1, 2019." See §11-21-12k(d)(2) (definition of "Newly registered business").
- These tax benefits last for a 10-year period beginning with the first full taxable year during which the Qualified Opportunity Zone Business first qualifies as such, or the first year in which the Qualified Opportunity Zone Business reports net income; provided, that the Qualified Opportunity Zone Business first qualifies as such on or after January 1, 2019.

Qualified Opportunity Fund Statutory Requirements

- A QOF must be a partnership or corporation.
  - Appears to permit S corporations, but the Proposed Regulations are silent.

- 90% of its assets in eligible property or eligible partnership interests or stock at two (2) semi-annual testing dates.

- Investment must be in “equity” for income tax purposes.
  - Preferred equity is ok.
  - Partnership interests entitled to special allocations, such as cashflow or liquidation preferences, are ok.

Qualified Opportunity Fund Self-Certification

- Corporations and partnerships can self-certify that they meet the requirements to be treated as QOFs.
- The IRS released draft Form 8996 with the Proposed Regulations.
- Entities that desire to be treated as QOFs must include Form 8996 with their regular tax returns.

Form **8996**
(December 2018)
Department of the Treasury
Internal Revenue Service

Qualified Opportunity Fund

▶ Go to *www.irs.gov/Form8996* for the latest information.
▶ Attach to your tax return. See instructions.

OMB No. 1545-0123
Attachment Sequence No. **996**

Name | **Employer identification number**

Part I **General Information and Certification**

1 Type of taxpayer: ☐ Corporation ☐ Partnership

2 Is the taxpayer organized for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund)?
☐ **No. STOP.** Do not file this form with your tax return.
☐ **Yes.** Go to line 3.

3 Is this the first period the taxpayer is a Qualified Opportunity Fund?
☐ **Yes.** By checking this box, you certify that by the end of the taxpayer's first qualified opportunity fund year, the taxpayer's organizing documents include a statement of the entity's purpose of investing in qualified opportunity zone property and the description of the qualified opportunity zone business. See instructions.
☐ **No.** Go to Part II.

4 If "Yes" on line 3, list the first month in which the fund chooses to be a Qualified Opportunity Fund. ▶

Part II **Investment Standard Calculation**

5	Total qualified opportunity zone property held by the taxpayer on the last day of the first 6-month period of the taxpayer's tax year. See instructions if Part I, line 3 is "Yes"	5	
6	Total assets held by the taxpayer on the last day of the first 6-month period of the taxpayer's tax year. See instructions if Part I, line 3 is "Yes"	6	
7	Divide line 5 by line 6	7	.
8	Total qualified opportunity zone property held by the taxpayer on the last day of the taxpayer's tax year	8	
9	Total assets held by the taxpayer on the last day of the taxpayer's tax year	9	
10	Divide line 8 by line 9	10	.

Part III **Qualified Opportunity Fund Average and Penalty**

11	Add lines 7 and 10	11	.
12	Divide line 11 by 2.0. See instructions if Part I, line 3 is "Yes"	12	.
13	Is line 12 equal to or more than 0.90? ☐ **Yes.** Enter -0- on this line and file this form with your tax return. ☐ **No.** The fund has failed to maintain the investment standard. Complete Part IV to figure the penalty. Enter the penalty from line 8 of Part IV on this line, and file this form with your tax return	13	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 37820G Form **8996** (12-2018)

Qualified Opportunity Fund – Purpose

- An investment vehicle organized as a corporation or a partnership for the purpose of investing in a Qualified Opportunity Zone Property.

- As we will see, “Qualified Opportunity Zone Property” can take several (three, really) different forms.

Qualified Opportunity Fund Assets Test

- A QOF must hold 90% of its assets in “qualified opportunity zone property,” which can be one of the following three items:
  1. Newly issued stock of a corporation,
  2. Newly issued partnership interest, and
  3. Tangible business property in a QOZ.

- In cases 1 and 2, for stock or a partnership interest to constitute qualified opportunity zone business property, the corporation or partnership must conduct a “qualified opportunity business.”

- Rules are much more lenient for investments into corporations and partnerships directly conducting qualified opportunity business(es).

Pre-Existing Entities

- A pre-existing entity can elect to be a QOF.
- Regulations allow a QOF (A) to identify the taxable year in which the entity becomes a QOF and (B) to choose the first month within that year to be treated as a QOF.
- However, only assets acquired by a pre-existing entity after 2017 counts towards the requirement that 90% of a QOF's assets constitute eligible property or investments.
  - Pre-existing entities with material pre-2018 assets electing to be a QOF would be at a disadvantage in meeting the 90% requirement.

Qualified Opportunity Fund Noncompliance Penalty

- Per month penalty for failing to meet 90% test:
  - Percent of shortfall x underpayment rate = penalty (Federal short-term rate plus 3%) – currently 5%.

- No penalty if it is shown failure is due to reasonable cause.

Qualified Opportunity Zone Business Requirements

- The QOF can opt for the qualified opportunity zone business route (i.e., investing in a subsidiary partnership or corporation), rather than directly investing in qualified opportunity zone property.

- In this case, that business in subject to the following requirements:
  1. 50% “active” gross income.
  2. Use of a substantial portion of the intangible assets in “active” business.
  3. 5% limit on financial assets.
  4. No “sin” business investments.

- Those requirements are inapplicable if the QOF directly holds qualified opportunity zone business property.

50% "Active" Gross Income and Asset Requirement

- At least 50% of the qualified opportunity zone business's gross income must be from the "active conduct" of a business in a QOZ.

- A corporation or partnership can meet the qualified opportunity business requirement even if only 70% of its tangible property is held for use in qualified opportunity zone business.

- A substantial portion of the intangible assets must be used in the active business.

50% "Active" Gross Income and Asset Requirement

- Proposed Regulations lack the definitions of:
  - "Active business" – Can triple net leasing qualify as "active?"
  - Can an active business be conducted by independent contractors (rather than employees)?
  - "Substantial portion" (i.e., 90%, 70%, or other)

Qualified Opportunity Zone Businesses

- A trade or business in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property and:
  - At least 50% of income derived from Active Conduct
  - Substantial portion of intangible property used in active conduct of business
  - Less than 5% unadjusted basis of property is nonqualified financial property

- Tangible property that ceases to be qualified opportunity zone business property shall continue to be treated as such for five (5) years or until no longer held (if earlier).

Generous Cash Rules for Start-Up Businesses

- General rules for holding cash and securities:
  - Amount of "nonqualified financial property" that can be held in business limited to 5% of the average unadjusted bases of property held in such trade or business.
  - "Nonqualified financial property" refers to debt, stock, partnership interests, options, futures, swaps and similar property.
  - Working capital held in cash (or cash equivalents) is not treated as "nonqualified financial property," provided (and to the extent that) the working capital safe harbor is met.

Generous Cash Rules for Start-Up Businesses

- Working capital safe harbor (no limit as to amount):
  - QOF needs to prepare a written plan to invest its cash in tangible property (real or personal) in the QOZ within 31 months.
  - Cash will not be treated as nonqualified financial property during that period.
  - Working capital must be expended substantially and consistently with the plan.

Holding OZ Property vs. Investing in OZ Business

Practical Example:

- If a QOF has $10 million in assets and wants to hold only $6.3 million in qualified opportunity zone business property, it can do so by investing $9 million in an operating partnership and having that partnership invest $6.3 million (i.e., 70% of its assets) in qualified opportunity zone business property.
- The operating partnership could hold the remaining $2.7 million in (a) cash of $450,000 (i.e., 5% of its assets) and (b) $2.25 million in non-qualifying tangible assets.
- The QOF could hold its remaining $1 million (i.e., $10 million less the $9 million invested in the partnership subsidiary) in cash, bonds, the S&P 500, etc.
- In contrast, if the QOF opted to purchase the qualified opportunity zone business property itself, it would have to buy $9 million of qualified opportunity zone business property, all of which would have to constitute tangible assets, and could then hold the remaining $1 million in cash, stocks, the S&P 500, nonqualifying real estate, etc.

Holding OZ Property vs. Investing in OZ Business

Requirement	Direct Investment	Indirect Investment
Percentage of Opportunity Fund's assets that must be invested in qualified opportunity zone business property	90%	n/a
Percentage of Opportunity Fund's assets that must be invested in stock or partnership interests	n/a	90%
Percentage of Opportunity Fund's assets that may be held in cash or other liquid investments	10%	5% plus reasonable working capital
Percentage of Opportunity Fund's assets that may be held in intangible property	10%	Unlimited, but intangible property must be used in trade or business
Percentage of Opportunity Fund's assets that must be invested in tangible property	90%	No minimum
Percentage of gross income that must be derived from Opportunity Zone	None	50%
Ineligible Businesses	None	Sin Businesses

No Sin Business Investments

- A qualified opportunity business may not operate the following so-called “sin businesses”
  - Golf course
  - Country club
  - Massage parlor
  - Hot tub facility
  - Suntan facility
  - Racetrack
  - Casino
  - Sale of alcohol to be consumed away from the premises

- *Prohibition on leasing real estate to such businesses?* Apparently not, so long as the qualified opportunity business is not operating the “sin business” itself.

Qualified Opportunity Zone Business Property

- Tangible property (e.g., equipment, real estate) used in business in a QOZ that is acquired after December 31, 2017 and is:
  - Land in QOZ.
  - Building in a QOZ that is first used by the QOF or the qualified opportunity business.
  - Building in a QOZ that was first previously used but is “substantially improved” by the QOF or the qualified opportunity business.
  - Equipment that was never previously used in a QOZ.
  - Equipment that was previously used in a QOZ but is “substantially improved” by the QOF or the qualified opportunity business.

The "Substantial Improvement" Requirement

- Applies to tangible property, other than land, that was used in a QOZ prior to its acquisition by the QOF (or the qualified opportunity business).

- "Substantial improvement" means the QOF (or qualified opportunity business) must invest more in the tangible property during any 30-month period than the adjusted basis in the property (excluding land) at the beginning of such period.

The "Substantial Improvement" Requirement

How does this rule interact with the bonus depreciation rules enacted as part of the Tax Cuts and Jobs Act?

- The bonus depreciation rules allow a taxpayer to fully expense certain assets (but not real estate) upon acquisition, resulting in a zero basis in those assets.
  - A literal application of the QOF rules in this context would mean that one cent of capital improvements could result in a substantial improvement to tangible property other than real property.

“Substantial Improvement” Requirement (Rev. Rul. 2018-29)

Practical Example:

- A QOF buys an existing commercial building for $10 million on March 1, 2019.
- Assume that $2 million is attributable to the land and $8 million is attributable to the structure.
- Under the rules, it appears that the building will satisfy the original use requirement if, at any time during the holding period of the building, the amount invested in rehabilitating the building over a 30-month period exceeds the adjusted basis of the building (no more than $8 million) at the beginning of that first 30-month period.
- *How many 30-month periods can the taxpayer wait to apply the substantial improvement requirement?*

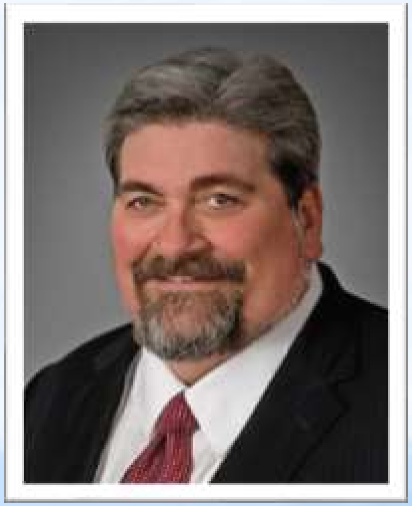
Readily Identifiable Investments in QOZs

- Commercial real estate development and renovation in opportunity zones.
- Opening new businesses in opportunity zones.
- Expansion of existing businesses into opportunity zones.
- Large expansions of businesses already within opportunity zones.

Regulatory Guidance Needed from IRS/Treasury

- Grace periods for Opportunity Fund and Opportunity Zone Business to make investments.
- Safe harbors permitting cash to be held for sufficient periods to construct or improve property.
- Clarification of the investor when a partnership recognizes a gain.
- Basis for applying various tests (i.e., adjusted tax basis or FMV).
- Meaning of “substantially all” and “substantial portion.”
- Clarification of “original use” requirement, especially with respect to vacant land.

Questions?



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Thank You!

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